

THE SCOTT LETTER: CLOSED-END FUND REPORT

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A Global View of the Closed-End Fund Industry

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THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site, www.CEFAdvisors.com, and in particular, read our article, *What Are Closed-End Funds*. Feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios.



— George Cole Scott
Editor-in-Chief

Emerging Market Funds Lure Investors: Mutual Fund Inflows Surge

In a sharp reverse of sentiment, investors pumped a record amount of money into equity funds focused on emerging markets in 2009. Emerging equity fund inflows into the emerging markets surged to \$80.3 billion, according to the research group EPFR Global. That was the highest influx since the group started tracking the data in 1997, compared with outflows of \$49.5 billion in 2008.

These inflows are \$25.9 billion more than the previous record in 2007 and contrast with the \$86 billion of outflows suffered by the developed world equity mutual funds in 2009.

The FTSE All-World Emerging Markets Index rose 75% by late December, far outpacing the 28% gain reaped by the FTSE All-World Developed Index.

Analysts said the emerging markets were valued at about 20x their trailing 12-month earnings compared to an approximate 7.9x during their March lows.

The world's biggest emerging market economies — Brazil, Russia, India and China (known as BRIC) — by year-end are in good shape for any type of stock market going forward. They accounted for the bulk of 2009's investor interest, with about \$60 billion of inflows.

Global emerging market equity funds, which mainly invest in the BRIC, have seen inflows of \$39 billion in 2009. Collectively funds that specifically invest in these countries have seen \$4.75 billion in inflows. China-specific funds have absorbed \$6.8 billion, Brazil-specific funds \$4.9 billion, India-specific funds \$3.1 billion and Russia-specific funds \$1.5 billion.

In recent months, flows have been boosted by funds that normally only invest in developed world stocks, as well as dedicated emerging market groups. According to

Financial Times, with industrialized economies expected to grow at much lower levels than their emerging market peers, investors expect greater returns from developing world stocks.

We telephoned Mark Mobius in Dubai on December 18, 2009.

SL: How are you, Mark?

Mobius: I am well. We are at Franklin Templeton's Dubai office, ready to leave. While talking to you, I am moving around. It is a holiday so I am working with one of the staff members as we talk.

SL: Really! I feel honored that you are taking time to talk to us with that busy schedule. Are you in Dubai to negotiate with them or looking for bargains?

Mobius: We are always looking for bargains. We have been through the entire Middle East: Libya, Algeria, Lebanon, Jordan, Saudi Arabia, Qatar and now Dubai. During the Dubai crisis, we were buying as it looks like things

will work out okay here. Dubai is a very impressive place.

SL: Our research shows that Dubai does have a huge presence in the world. The city-state's January 4th opening of the Burj Dubai, the world's tallest skyscraper at 2,717 feet, a \$20 billion development built by Sheik Mohammed, is the world's tallest building. It is expected to enhance his reputation among international investors and restore Dubai's allure as a business hub. The "Dubai Strategic Plan" shows that its future has been well worked out. Dubai has a historic growth rate faster than China and India.

The world's financial community has been shocked because of a debt standstill focusing on the repayment of \$4 billion to Dubai World's developer. Forecasts estimate that real



Dr. Mark J. Mobius

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estate prices could drop further there in 2010. How did they get into such financial trouble?

Dubai World shares closed at \$0.45 on January 6, 2010, down from its 52-week high of \$0.60.

Mobius: They got into trouble because of too much short-term debt which needs to be rearranged to line up with the cash flow. Cash flow is still good, and the hotels are full. Hotel rates have not come down, which disappointed me as I was hoping to get a nice cheap room rate here, but that was not the case.

SL: That fits the Templeton philosophy. I remember that when Sir John Templeton came to Richmond a few years ago, the billionaire said he always flew coach which made an impression on me.

Mobius: When I was here two weeks ago, the hotel was packed with Russians and others. When more hotels come on stream, occupancy may decline, but still many people are coming, looking for apartments and vacationing. The Emirates Airline, now one of the foremost airlines in the world, is bringing them in by the boatload. Things will be all right, but the debt situation won't be worked out for some time before rolling along.

SL: It is good to hear your usual optimistic answers, which always seem to work out. However, other countries such as Greece are also in trouble and are adversely affecting the world markets.

Mobius: Greece, as you know, is not an emerging market. I don't have concerns about it, once they cut their budget. They are in trouble but will pull through because a lot of reform is taking place within the European Union, and the Greek government is being forced to reform.

In Dubai and Saudi Arabia, a lot of bank lending was based on name – people who were trusted with no collateral taken. This worked for a long time, but as the amounts grew, it became unsustainable. Now with good faith and credit, they are dealing with it. The Dubai government says that there is no state guarantee; they will have to make their adjustments accordingly. Commercial lending decisions will have to be based on an analysis

of each project which will change the tone of the lending.

The people in Dubai apologized for not being transparent. They will now be more open, which will help market sentiment. Therefore, we are optimistic about the situation. I have been coming to Dubai for about 15 years, and it has been transformed overnight. The government and the sheik have incredible ambitions and a vision that is probably unequalled in the world, maybe even more so than in China.

SL: There was a sharp reaction in the world markets.

Mobius: Not that much as the markets quickly recovered. There hasn't been a knock-on effect. I would like to see a correction in these markets so we can get better prices. The reaction was minimal because the growth of the money supply has been creating a high degree of liquidity so there was no need for panic.

SL: As you know, stock markets hate uncertainty. They dropped sharply, but they seem to have stabilized now. All of this was going on while the U.S. and the global economies were making progress in recovering from the recession.

How concerned are you about the high price/earnings ratios in many of the emerging markets?

Mobius: The P/E's have come up, but we are coming from a very low base. We have seen market increases of 80%, 90%, 100% from the bottom in many of these markets. If you look at the average for the last 10 years, you will see that the low point was about 1x book value, and at the high, was about 3x book value. We are now about 2x book value.

It appears we are in the middle of the valuation range, not as cheap as we were, but when the markets were cheap, everybody was taking money out. Now we are finding value. In the U.S., you can only get 1% at the banks so I think this bull market has more to run.

SL: Do you think that the commodity boom has ended or slowed down?

Mobius: The trend is up, and it is not a bubble. It is in a steady trend upwards, but there will be fluctuations. There are shortages in a number of commodities such as agricultural goods and metals. We, there-

fore, have a very heavy weighting in oil companies as well as in consumer stocks.

[Editor's Note: The International Monetary Fund forecasted that commodity prices are set to rise further in 2010 as the global economy expands faster. This follows the biggest annual price increase for raw materials in nearly four decades in 2009, according to a recent report in *Financial Times*.]

SL: For the rest of this report, we will focus on the so-called BRIC countries – Brazil, Russia, India and China, but in reverse order because of the importance China has to the rest of the four.

China

SL: The Templeton Emerging Markets Fund, which we hold in our clients' portfolios, has large positions in the BRIC countries. The August 31, 2009 Annual Report shows that it had 16.4% of the portfolio in China, 11.0% in India, 7.6% in Russia and 21.2% in Brazil (the largest allocation).

Has China been able to maintain its global economic leadership in the world with its many infrastructure problems?

Mobius: There is no question China will maintain their economic leadership and will strengthen it. With their large foreign reserves, they can easily increase their holdings of commodity companies in Africa – and not only in mining companies. They are also building railroads, so they can get those commodities out. I think that China is in a very strong position and will probably continue to be so going forward.

[Editor's Note: According to *The Wall Street Journal*, China has just reported that its economy was growing faster, is more services-based and closer to overtaking Japan as the world's second largest economy than previously estimated.]

SL: Do you think that it is possible that the U.S. may someday have a trade surplus with China as our economy grows?

Mobius: That could possibly happen if the U.S. dollar continues to weaken, but I don't think that is likely. The U.S. has the capability to be a big exporter, but only if the dollar weakens. There have been some competitive devaluations taking place in

the world, but China is still keeping its currency tied to the U.S. dollar and thus, is effectively devaluing against a number of other currencies as the dollar devalues.

SL: China has had a massive stimulus program, which may be as much as half of their GDP, and their money supply has risen as much as 29%. What are your comments about that?

Mobius: That is one of the growth drivers for China and is one reason that the markets have a long way to go. When you look at the slower money supply growth in the U.S. and the rate of 20% in China, incredible liquidity has been created.

There are two big elephants in the room: money supply and derivatives. With derivatives, it makes risk-taking possible. People think they can control risk with derivatives, however, they are taking more risk in the equity and debt markets.

[Editor's Note: Dr. Mobius wrote recently in his on-line weekly blog that one of the key things he looks for when visiting a company, among other things, is their exposure to derivatives. He wrote:

"We are aware that there have been significant losses from derivatives in many companies, not just in India, but also in Mexico and China. Therefore, understanding a company's exposure to derivatives is an important question that we ask management when we are looking at balance sheet and profit and loss statements."

To read Mobius' blogs, visit <http://mobius.blog.franklintempleton.com>.]

SL: Are you aware that there are four million cars in Beijing now, as one in four of their 16 million residents own a car? They can't expand their subway system fast enough, so the roads are overloaded. Don't you think that transportation mess may be elsewhere as well?

Mobius: Yes, there are big transportation jams in all of these emerging markets. Here in Dubai, on a workday, you have traffic jams on a 6-lane highway running through the heart of the city. In China, you have traffic jams everywhere because of the push for more cars. More cars are being sold in China now than in the United States, as every Chinese wants a car.

SL: That makes me glad I live in a smaller city that seldom has traffic jams.

What other economic factors are keeping China moving?

Mobius: The government is very aware of the risks, and they are doing their best so people can be employed and their aspirations be met. They are becoming a lot more sensitive to the consumer, a very important factor, so we have to keep an eye on that going forward.

[Editor's Note: In addition to holding shares in Templeton Emerging Markets Fund (NYSE:EMF), clients of Closed-End Fund Advisors (CEFA) also hold other funds that invest in China: Templeton Dragon Fund (also managed by Dr. Mobius) as well as Asia Pacific Fund and Greater China Fund.]

India

SL: Have you visited India recently? I was there once and found it a fascinating and colorful place, full of friendly people.

Mobius: Yes, I was in Mumbai and other places a few weeks ago and found a lot of improvements. My visit reinforced my previous assessment that the growth rate in India will likely continue. The Indian companies we visited indicated that their businesses are growing above expectations and that the downturn in the U.S. and in Europe didn't affect them as much as they expected. We find that there are still opportunities in this market. We are making some strategic investments in Indian companies.

The Indians are more straightforward than the Chinese because they don't have the reserves the Chinese have. The people at India's central bank are very intelligent and thoughtful. With the Congress Party in power now, they can implement more things quickly. That is a good step in the right direction.

SL: What is the expected growth rate in India for 2010?

Mobius: The growth rate of India remains surprisingly high. They are in the take-off stage now and will continue to have growth of 6% or more.

SL: There have been large amounts of new stock issues (IPO's) coming out of India. What are your thoughts about this?

Mobius: Not only are there many new offerings coming out of India, but we calculate that there is a waiting list of about \$250 billion of new IPOs scattered among 300+ companies waiting to come to the market. There is a lot of money to be raised for acquisitions and expansion, which will strengthen company balance sheets.

SL: Despite that good news, you know that there is still a lot of poverty in India. The recent serious drought has worsened conditions because of the poor monsoon season. It is also clear that agricultural production has suffered due to a combination of climate change and air pollution. Do you see this as a continuing problem for India and other nations?

Mobius: Yes, it is a big problem, not only for India, but countries around the world are facing serious water shortages. In country after country, the lack of water is becoming a major problem. In China, desertification is also a problem. Hydro-electric plants in many places are not producing as much so that is a big challenge for many countries that has to be tackled on an international level.

SL: There has been much concern about water shortages in the media lately. You may have read that the glaciers in the Himalaya plateau are melting faster than expected, affecting India, China and other nations. *Time* magazine reports in its December 14, 2009 article, "Global Warming Doesn't Just Threaten Polar Bears":

"The real threat is to the heart of the greater Himalayas and the vast Tibetan plateau, where more than 40,000 square miles of glaciers hold water in the largest collection of land ice outside the Polar Regions. The high altitude glaciers of the Himalayas and the Tibetan plateau – which cover parts of India, Pakistan, Nepal, Bhutan and China – are the water towers of Asia. When the ice thaws and when the snow melts every spring, the glaciers birth the great rivers of the region, the mightiest river system in the world.... Together, these rivers give material and spiritual sustenance to three billion people, nearly half of the world's population – and are all nursed by Himalayan ice."

Do you think the Copenhagen conference will bring about any sustainable agreements?

Mobius: I think there will be some kind of agreement because they have to. Carbon credits are going to be very big business going forward.

[**Editor's Note:** According to *The New York Times*, approximately 30 of the smaller nations meeting at Copenhagen are responsible for 90% of global warming emissions. It is encouraging that they will meet periodically to tackle a narrower agenda of issues, like technology-sharing or the merger of carbon trading markets. Despite much pessimism about the conference, the delegates made significant progress on sharing clean energy technology and exchanges between American and Chinese environmental officials over ways to accurately measure greenhouse emissions, among other things.

For more information, see Worldwatch Institute's "State of the World 2010" annual report. The report updates "transforming cultures and consumerism". It is available at www.worldwatch.org.]

SL: Mark, there appears to be some concern that many countries may be moving away from the U.S. dollar. For instance, the Indian government has recently been selling dollars for gold because of concerns about the stability of the massive spending by the U.S. What are your thoughts about this?

Mobius: There is a move away from the U.S. currency and from some of the central banks because of concerns about the U.S. dollar. There is also some selling of the Euro because of what is happening in Greece.

When The People's Bank of China said that they were diversifying away from the U.S. Treasuries, the dollar got hit that day.

China feels very uneasy about holding a currency from a government that is continuing to spend at an alarming rate, both globally and at home. All of this can be quite alarming to anyone holding U.S. Treasuries and dollars. (1) You have seen these countries move to the shorter end of the Treasury market. (2) They are mopping-up any gold that is available, and

(3) They are using their reserves to invest outside the dollar as a hedge.

SL: That is something which concerns all of us, especially since some of the BRIC countries are doing better balancing their budgets than the U.S.

[**Editor's Note:** CEFA clients have exposure to India through EMF and Asia Pacific Fund. The only pure play is through the India Fund, which is only held by some of our larger clients, because of its higher volatility.]

Russia

SL: We have had a harder time getting solid information about what is really going on in Russia, so we hope that you can fill us in, especially on how they are improving their infrastructure.

I recently saw President Medvedev on c-Span television. He said that their national debt increased 30%, but he added that their inflation rate dropped to 9% from 13% and that they are trying to diversify away from energy production. Do you spend much time in your Moscow office?

Mobius: Yes, we go there quite often. We have been increasing our holdings in Russia and are not as pessimistic about what the Russians are doing, as some others are.

Russia is definitely improving their relations with Europe. They are getting more confident, and their foreign reserves are going a long way to help other countries. For instance, they helped to bail out Iceland, a NATO member. Since NATO didn't come to their assistance, when Iceland was in serious financial straits, the Russians helped them out. I think that Russia are moving in the right direction.

Their oil and metals companies are doing very well. Oleg Deripaska, one of the oligarchs, is trying to list his aluminum company in Hong Kong, a sign of the times. This is a way to move a company into stock markets where there is a lot of money to be invested. It will be interesting to see how this plays out.

Russian commodity stocks are high on our list, but we are also looking at the consumer market because the Russians are consuming more as their per capita

incomes rise. It is a good market to which we want exposure.

Some of the oligarchs have liquidity problems so they went to the government for help. There was also quid pro quo in that the government was in a stronger position to get what they wanted from the oligarchs. That is something we watch.

SL: It surprises me that Russia is in a cash position to bail-out failing countries. Is this because of its oil revenues?

Mobius: Yes, they have gotten about \$700 billion in oil reserves, making them the third largest in the world after China and Japan.

SL: A year ago, you told us that \$70 a barrel was "about right" for oil when it was under \$40, and now (January 5, 2010), it is over \$80. Has that been significant for Russia?

Mobius: They need \$100 dollars a barrel to dramatically increase their reserves. They make money at \$70, but they cannot depend on oil alone. They have to diversify their economy and have the capability to do so. We will, therefore, see more diversification.

SL: President Dmitry Medvedev said the same thing. What has the Russian Federation government done to improve the infrastructure and to reform the tax and banking sector?

Mobius: The good news is that the tax levels in Russia are very low. In terms of infrastructure, they are definitely moving ahead. However, it takes a lot as it is a big country. To change the tax level will also take time, but they are definitely moving in the right direction. They certainly have the money to do what they have to on taxes and the infrastructure.

[**Editor's Note:** Russia is indeed a big country geographically, with 11 time zones. The Population Reference Bureau has projected that Russia's population is declining to more than half of that of the U.S. – estimated at 141.8 million in mid-2009 due to a low birth replacement rate (less than its death rate).]

SL: Regarding the infrastructure, we note that Russia has just opened its first high speed rail line between St. Petersburg and Moscow, and another is planned for 2011 to link St. Petersburg with Helsinki.

Do you think that Russia will make it into the World Trade Organization (WTO) as the timeline keeps slipping?

Mobius: I think so, as there are so many advantages in being in the WTO that they will try their best. It makes a lot of sense for them to be a member.

[Editor's Note: According to *Financial Times*, Vladimir Putin, Russia's prime minister, recently stated that Moscow is trying to restrain the capital inflows that have caused the ruble to strengthen in recent months. This threatens the country's delicate economic recovery following the global financial crisis.

CEFA clients' only exposure to Russia is through their investments in EMF.]

Brazil

SL: Do you plan on spending time in Brazil and other Latin American countries in January as usual?

Mobius: Yes, I will be there in January. We will be visiting Mexico, Chile and Argentina.

SL: Brazil has shown the world that they have survived the global financial crisis, and Brazil's economic recovery could be even stronger in 2010 than first thought. The Central Bank of Brazil said recently that the country's growth could swell to 5.8% in 2010, up from most estimates of 5%. Brazilian financial markets reacted favorably to this report.

Brazil's stock index was the strongest in the world, up 82.7% in 2009, even more than those in Hong Kong and China, which were up 52% and 80%, respectively.

Are the higher valuations the reason you switched your holdings in Petrobras, Russia's state oil company and Vale do Rio Doce, SA, its large mineral company, to the preferred shares?

Mobius: We see it as a liquidity issue. They are great companies, and we invest where we can find the highest liquidity.

SL: Do you think that there are better bargains with the smaller cap stocks?

Mobius: There are some bargains among the small cap stocks, but the larger caps are not that much more expensive. In many cases, they are cheaper.

SL: We also noticed that you have reduced your exposure to the banks. Is this a result of the entry of Spain's Banco Santander into Brazil?

Mobius: Banco Santander has made good money in the region. The banking sector has been on fire in Latin America. The best banks in the region are Brazilian because they have lived through and survived hyperinflation and, as a result, are very well qualified to handle anything that comes along. In addition, they are strong in the consumer area. We expect the banks in Brazil to continue to do well, and that is why we hold large bank positions.

[Editor's Note: According to *The Wall Street Journal*, Brazil's banks are concentrating on local rather than global growth on the bet that Brazil will stay Latin America's dominant growth story. The story only becomes more compelling in the run-up to the 2014 World Cup and the 2016 Olympics, both to be hosted in Brazil.]

SL: What can you tell us about Brazil's strong currency appreciation?

Mobius: The currency has appreciated, but we have to be careful because they decided to impose a 2% tax on currency inflows due to worries about currency appreciation. It will be interesting to see how this pans out because they don't like to see their currency get too strong as their exports will get hit.

SL: We note that Brazil became the first of the big emerging market countries to tax capital inflows in an attempt to discourage short-term, hot money from flowing in, much of it from the U.S. We are aware that Brazil-U.S. relations have suffered lately.

Mobius: Brazil has become more and more important, but the country has never cared about pandering to the U.S. They are independent and will not try to please the U.S. in any direction, so that will continue.

Brazil is not happy in the way the U.S. does not allow their ethanol to be imported into the U.S. Ethanol produced from sugar cane is so much cheaper than ethanol produced from corn. The Brazilians say it doesn't make much sense that the U.S. is producing ethanol from corn rather than from sugar. Tension will be there, but I

think that relations with the U.S. will be reasonably good going forward.

SL: The ethanol export problems for Brazil were the result of the policies of the Bush administration. Now that the new administration is emphasizing alternative energy, the differences over ethanol should subside as much of this fuel is being phased out for environmental reasons. Brazil has done a better job with renewable energy than we have.

[Editor's Note: According to *The Wall Street Journal*, Brazil's successful experience in renewable energy, an impressive 47% of the country's energy mix, compares very favorably with the global average of just 13%. Brazil makes large scale use of hydropower as well as flex-fuel cars that run on sugar cane-based ethanol which for decades have helped Brazil fight global warming.]

Brazil's President believes that developing countries should be an equal part of the global warming solution. At Copenhagen they announced they will reduce Brazil's CO₂ emissions between 36.1% and 38.9%.

Brazil is also committed to cutting deforestation by 80% in the Amazon. In 2009, deforestation of the Amazon dropped 45.7% compared to 2008, a testament to Brazil's earnestness. These proposed reductions in emissions from deforestation alone will be larger than those offered by many developing countries at the Copenhagen conference. Brazil's government is now keeping track of who owns land in the Amazon and who should be held accountable when the forest is cleared illegally to reduce deforestation.

All of this is a part of worldwide efforts for a continuing rise in living standards. We see this as the *raison d'être* for what you do, Mark. When there is hope, it can give the people in the emerging markets a means to choose and improve their own destinies. Part of this comes when they can invest in their own markets which, I know, you encourage. That will help make significant progress in improving the quality of life in the emerging world.

[Editor's Note: CEFA clients not only have a large exposure to Brazilian equities through EMF and some of our other global

funds, but they also hold the two regional funds, Latin America Equity Fund and the The Latin American Discovery Fund.]

Templeton Emerging Markets Fund Annual Report

Because our interview with Dr. Mobius primarily covers the four largest emerging markets countries, we decided to reprint a portion of EMF's August 31, 2009 Annual Report in which he covers the smaller countries in this portfolio.

Investment Objective: The Fund seeks long-term capital appreciation by investing, under normal conditions, at least 80% of its assets in emerging markets equity securities.

Templeton Emerging Markets Fund had cumulative returns of -1.27% based on market price and -5.54% based on net asset value for the 12 months under review.

Investment Strategy: Our investment strategy employs a bottom-up, value oriented, long-term approach. We focus on the market price of a company's securities relative to our evaluation of the company's long-term earnings, asset value and cash flow potential. As we look for investments, we focus on specific companies and undertake in-depth research to construct an action list from which we make our buy decisions. Before we make a purchase, we look at the company's potential for earnings and growth over a five-year horizon. During our analysis, we also consider the company's position in its sector, the economic framework and political environment.

Economic and Market Overview: The 2008 financial crisis drove significant corrections in global stock markets as extreme risk aversion led investors to shy away from most forms of investments including equities. Emerging markets were no exception, as Morgan Stanley Capital International (MSCI) Emerging Markets (EM) Index declined more than 50% in U.S. dollar terms from the beginning of 2008 to reach a year-low in October 2008.

Markets subsequently traded sideways for about four months as governments globally implemented fiscal stimuli and

loosened monetary policies to support their domestic economies and ease liquidity conditions.

Partly as a result of these efforts, emerging markets stocks, which recovered much of their 2008 decline, returned +71.13% in the last six months of the reporting period and -9.96% for the 12 months. Part of this decline was due to weakness in emerging market currencies as the U.S. dollar benefited from funds seeking a safe haven during the earlier part of the period.

Stock markets in eastern Europe were the weakest emerging market performers during the 12-month reporting period due to concerns about the financial state of European banks and current account deficits in several European countries, including the Baltic states. Eastern European markets, however, outperformed their emerging market counterparts in the latter half of the reporting period with a six-month total return of +91.41%.

Turkey's stock market delivered a +19.72% total return in local currency terms for the year, but a weak lira reversed the gains. The market had a 5.40% return in U.S. dollar terms.

Asian stock markets, on the other hand, outperformed their emerging market peers as signs of economic recovery and improved investor confidence led to significant inflows. Chinese equities were among the top performers during the period. China remained one of the world's fastest growing major economies, as gross domestic product in the second quarter of 2009 accelerated to 8% from 6% in the first quarter, year-over-year.

In Latin America, Brazil and Mexico were adversely affected by weaker domestic currencies and a correction in commodity prices. Close economic ties with the U.S. further impacted the recession-burdened Mexican economy.

Manager's Discussion: For the 12 months under review, among the most significant detractors from the Fund's absolute performance were CNOOC (China's offshore oil and natural gas exploration and production company), Victory City International Holdings (a Hong Kong textile maker with production facilities in

Templeton Emerging Markets Fund As of December 31, 2009	
NAV Average Annual Total Returns (as of December 31, 2009)	
1-Year	106.95%
3-Years	10.20%
5-Years	17.17%
10-Years	10.63%
Market Price Average Annual Total Returns (as of December 31, 2009)	
1-Year	117.51%
3-Years	10.76%
5-Years	16.94%
10-Years	11.21%

China) and Oriflame Cosmetics (a Swedish cosmetics company). We divested the holdings in CNOOC and Oriflame Cosmetics due to availability of attractively valued stocks elsewhere in our investment universe.

On a positive note, the most significant contributors to the Fund's absolute performance during this review period included China's Denway Motors, Brazil's Itau Unibanco Holding and Chalco (Aluminum Corp. of China). Denway Motors and Honda produce and sell the Accord, Fit and Odyssey models.

We increased the Fund's holdings in Denway Holdings during the reporting period, and based on our analysis, we maintained a positive long-term view on China's automotive sector, where low market penetration rates and government efforts supporting the sector could point to considerable growth potential.

Itau Unibanco Holding is one of Brazil's largest financial conglomerates that provide a full range of banking and financial services. The merger between Itau and Unibanco in 2008 allowed the joint company to unlock hidden value, which had a positive impact on stock prices. We believe the continued liberalization of Brazil's financial sector and growing financial needs of the region's consumers could further benefit Itau Unibanco Holding.

Chalco (China's leading producer of alumina and primary aluminum products) recorded significant price declines in the

earlier part of the year due to commodity price corrections and demand concerns amid growing global growth. Since then, Chalco's share price has regained some ground. Although commodity prices are down from their 2008 peaks, we believe they could trend upward in the long term, benefiting companies such as Chalco.

It is important to recognize the effect of currency movements on the Fund's performance. For the 12 months ending August 31, 2009, the U.S. dollar rose in value relative to most currencies. As a result, the Fund's performance was negatively affected by the portfolio's investment predominately in securities with non-U.S. currency exposure.

We sold a number of holdings during this review period as stocks reached sale price targets or were no longer attractively valued in our investment universe. As we raised funds for income and capital gain distributions, we reduced the Fund's investment in semi-conductors, oil and gas, and telecommunications services compa-

nies as well as the Fund's exposure to Taiwan, Poland and Turkey.

During the reporting period, we made select purchases in diversified metals and mining, food retail and IT consulting companies as price corrections made valuations more attractive in our view. We also increased the Fund's investments in India, South Africa and Brazil.

Key additions included U.K.'s Anglo American (an international natural resources group), Welmex/Wal-Mart de Mexico (the largest retailer in Latin America) and India's Tata Consultancy Services (a major IT consulting company).

Thank you for your continued participation in Templeton Emerging Markets Fund. We look forward to serving your future investment needs.

— Mark Mobius, Executive Chairman
Templeton Asset Management Company

For more information on EMF, visit www.franklintempleton.com or telephone 800-342-5236. ■

Portfolio Manager's Review

There's no doubt the economy is improving as consumers and business managers spirits were buoyed by the 3.5% U.S. annual growth rate for the third quarter, which continued to gain for the fourth. Now that the dismal stock markets of the early part of 2009 are over, we see continued progress for 2010.

The average closed-end fund was up 53.4% at year-end as many funds have started to make up for the 2008-2009 negative returns. Factors contributing to this are the continued improvement in the global and equity markets, very low leverage costs and low yielding alternative income-oriented investments which make closed-end funds with attractive income distributions more appealing to investors who are increasingly willing to take more risk in their portfolios.

The portfolio managers at Closed-End Fund Advisors have participated in the search for increased yield while reducing risk during their annual portfolio rebalanc-

ing in October and November. Purchases included adding to classic funds like Adams Express and General American Investors, as both funds were selling well below their highs.

We also have purchased new positions in such funds as Cohen & Steers Closed-End Opportunity Fund, which gives the shareholder significant fund diversification as well as good income. Several high quality bond and closed-end REIT funds were also purchased before year-end market strength narrowed their discounts. Several funds trading at significant premiums to their net asset values were eliminated.

By year-end, all of our client portfolios were in good shape for the year to come. We will next be interviewing Khiem Do of the Asia Pacific Fund. It will be released April 1, 2010. ■

George Cole Scott

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